PUBLIC

EMI Music North America

TESTIMONY OF

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Vice Chairman
EMI Music

Chairman and CEO
EMI Music North America

New York, NY

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Washington, D.C.

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TESTIMONY OF DAVID MUNNS

Background and Qualifications

My name is David Munns, and I am currently Vice Chairman of EMI Music worldwide ("EMI Music") and Chairman and CEO of EMI Music North America. I have spent more than thirty years working in numerous facets of the music business. That work has given me a broad perspective on the state of the recorded music industry today and allows me to contrast our situation with that of the music publishers. Based on my extensive experience in the music business, I am testifying to demonstrate the importance of the outcome of this proceeding to EMI and the recording industry as a whole.

I began my career at EMI Music in 1972 and held various marketing positions at EMI UK and EMI Canada, ending up as the head of A&R and Marketing at EMI UK. In 1987, I went to PolyGram as Managing Director of Polydor UK, then became worldwide Senior Vice President of Pop Marketing in 1991. In that position, I oversaw all of PolyGram's frontline repertoire across 53 subsidiaries. In 1998, I left PolyGram to manage the well-known recording artist Bon Jovi. In 2001, I returned to EMI Music as Vice Chairman. In 2002, I assumed responsibility for running EMI's North American operations.

EMI Music's roster includes more than 1,300 recording artists worldwide and more than 300 in North America. Our record labels span all musical genres and include Angel, Astralwerks, Blue Note, Capitol, Capitol Nashville, EMI, EMI Classics, EMI Christian Music Group, EMI Music Canada, EMI Televisa Music, Mute, Parlophone and Virgin. We have vast catalogue holdings including over 3 million recordings. Our music roster includes legends such as The Beatles, the Rolling Stones, Pink Floyd and Mstislav Rostropovich, and more recent superstars like Norah Jones, Robbie Williams, Gorillaz, Coldplay and Keith Urban. During my years in the music business, I have personally worked with a broad array of artists including, to name a few, Paul McCartney, Queen, The Cure, Van Morrison, Kate Bush, Bon Jovi, Kraftwerk, Gorillaz and Pet Shop Boys.

Introduction and Summary

The recording industry is going through the most profound and dramatic transition that I have seen in my more than thirty years in the music business. Conditions are much harsher than they were in 1981, when the mechanical royalty rates were first set, and the marketplace is undergoing fundamental and permanent changes. Since 1997, when rates were last set for mechanical royalties, we have had to adapt from selling only physical products to selling both physical and digital products. The development of digital music products has had an impact far greater than prior format changes in the recording industry. Through all the past transitions from one physical format to another – from LP to cassette, from cassette to compact disc – we remained essentially a one-product industry.

This format shift is profoundly different because we have been forced to adapt quickly to become a multi-product industry offering an array of digital products from downloads to ringtones, all of which have to be supported on multiple platforms and in multiple formats. Accordingly, we are in the process of designing and implementing an entirely new method of promoting, distributing and selling the numerous physical and digital products that we generate for each album. With the proliferation of products and platforms, the uncertainties that the record industry faces in the new marketplace are much greater than 25 or even 10 years ago.

We face significant challenges as we reposition EMI Music for the new digital era – while the same marketplace upheaval has little effect on music publishers. The factors we have to contend with during the digital transition include:

- the tremendous costs of migrating our business to digital products and distribution platforms and at the same time pursuing our legacy physical product business with a diminishing base of sales;
- the fragmentation of media outlets and pressure on marketing costs as we seek not only to sell specific albums but to create artist brands that will support sales of multiple albums; and
- the devastating impact of piracy on the recording industry as we are forced more than ever before to compete with free.

As we strive to meet these challenges, the mechanical royalty rate that is being set in this proceeding matters deeply and fundamentally to EMI Music. In an era when we are forced to watch every penny as we try to create exciting new sound recordings, the current mechanical license "penny rate" impedes our ability to earn a fair income from our sound recordings. The rate is both too high and too inflexible to adapt to evolving business models and new technologies. Greater flexibility would benefit both the publishers and the recording industry. After all, publishers and songwriters get paid every time we sell a sound recording – but we can only succeed in our business if we can afford to invest in the creation of new sound recordings and market our catalogue of sound recordings in novel and innovative ways.

In my testimony, I will provide an overview of the current situation in the recording industry. I will discuss some of the significant challenges facing the recording industry and EMI Music at this point in the digital transition, and how those challenges have a disproportionate impact on the recording industry in contrast with the music publishers. I will conclude by describing the importance of the mechanical rate to the recording industry and the appropriate rate and rate structure required to support the industry in this difficult time (including the need for a percentage royalty rate in order to more fairly distribute the risk borne by record companies).

I. THE CHALLENGES OF THE DIGITAL REVOLUTION FOR THE RECORDING INDUSTRY

EMI Music has been in the forefront of the digital revolution that has transformed the recording industry since the mechanical rate was set in 1981. We have eagerly embraced new products and business models that will allow us to make our sound recordings available on all digital distribution platforms. We were the first record company to release a digital album for download when we released David Bowie's *Hours* in 1999. In 2001, we launched the first Internet video single, Lenny Kravitz's *Dig In.* As compact disc ("CD") and other physical product sales continue to decline across the recording industry, EMI Music's digital revenue streams are steadily increasing. The long-term future of EMI Music is tied to digital music, and we have devoted enormous resources to turn ourselves from a one-product company into a music-centered, multi-platform content company that offers a broad array of products. We hope to be on every legitimate digital music platform so consumers can obtain our sound recordings in any way they choose.

Embracing the digital future of the music industry has come with tremendous costs and the need for enormous investment during this transition period when we are still affected by the decline in physical sales. Our rapidly increasing digital sales are not yet significant enough to make up the difference. I will highlight three challenges that were not present in 1981, or even in 1997: (1) the costs of migrating our business to digital products and distribution while also pursuing our legacy physical product business; (2) the challenge of changing our focus from selling a single product to creating and marketing artist brands across multiple digital platforms; and (3) the significant effects of piracy.

A. The Tremendous Costs of Migration to Digital Products and Distribution

The future of the recording industry lies primarily in new product and service offerings and new channels of distribution made possible by the digital revolution. Future industry growth will come from identifying and investing in new opportunities resulting from these innovations in digital technology. To succeed in the new marketplace, we must develop multiple streams of income from a wide variety of products, formats and distribution platforms, all of which will continue to evolve and change at a rapid pace. Harnessing these new markets and technologies requires significant up-front investment to support digital delivery in general, to develop new types of product and service offerings and to produce specific digital products that are compatible with various delivery means. At the same time, the marketplace for new digital offerings is risky and uncertain, and we do not yet know which of the new formats and distribution channels will have a lasting impact on the marketplace.

In 1981 (and even ten years ago), we basically distributed no more than a few types of physical products such as LP records, cassette tapes, and CDs. Consumers either bought those items or listened to music on the radio. Today, we still have to provide physical products for a declining but very significant market. In addition, we must provide multiple digital products, including full-length sound recordings (albums and individual tracks), music videos, ringtones, ancillary content such as "making of" documentaries and more. Today, for each album we release, we often prepare up to 75-100 separate products. For example, for the recent Coldplay *X & Y* album, we have 93 separate "saleable items" in the U.S., including physical and digital products. See RIAA Ex. B-201-DR. As we create these products, we do not know which ones will generate enough revenue to cover the costs of production. For example, about [redacted] of the ringtones we prepare and distribute do not meet this standard.

We often confront the erroneous assumption that digital music distribution costs less because it involves no delivery of a physical product. This assumption is incorrect. Although the wholesale price for digital tracks is usually lower than the price for comparable physical products, thus far there has been no equivalent cost savings from the transition to digital products. Obviously, we save on manufacturing costs. But at the same time, digital content distribution requires its own distinct distribution chain, which generates significant costs that consume any savings in manufacturing costs. Creating that digital distribution chain has required substantial investment over the last six or seven years. During the most recently completed fiscal year, digital distribution accounted for [redacted] of EMI Music's total North American revenues, leaving little base to support these high infrastructure development costs.

Some of the costs arise because the digital music business is much more complicated and fragmented than the physical sales business. Consumers today spread their consumption of sound recordings over a wide variety of services. To remain viable in the marketplace, a record company has to be ready to provide content for all of these services. We have incurred substantial costs to service diversified distribution outlets and platforms. We are also required to distribute products in multiple formats due to different technical requirements and the lack of interoperability among various music delivery devices. We must also provide individualized service for each new digital distributor account, in addition to all the existing physical accounts that we continue to service. While for every account we devote resources to establishing the initial relationship as well as to ongoing sales, marketing, and supply chain support, many of the newer digital retailers have never been in business before and require more time and attention from our sales personnel.

Establishing the initial relationship is often much more complicated in the case of digital distributors. Unlike physical products, where every distributor buys and resells basically the same product, digital products are distributed through numerous types of services, and we are regularly presented with ideas for new types of services. We must frequently devote significant staff time to working with the digital music provider to define the service, analyze its financials, and negotiate a distribution agreement tailored to each product and each service. While we have been forced by declining revenues to make significant staff cuts elsewhere, we have had to increase the personnel devoted to digital deal-making and deal support. In recent years, EMI Music established central digital strategy and development departments at the worldwide and North American levels to negotiate, draft, and administer our digital deals. We have also created a dedicated global digital operations department, which manages our digital supply chain. Similarly, in recent years, EMI Music's distribution companies, our central mechanical licensing and royalty departments, and each of our label groups, have also created new positions dedicated to supporting digital marketing, digital sales and related royalty and other financial services. Almost all of these positions did not exist prior to the late 1990s.

In addition to these ongoing costs related to the continued development of our digital business, EMI Music is in the midst of the very expensive process of developing multiple electronic systems required to support digital products, their distribution to various platforms, and the administration of digital sales. We expect our investment in this process to continue through at least the next five years. Our digital sales will grow during that period, but in the meantime, we will have to risk significant investment to establish the systems that will allow us to develop multiple revenue streams from multiple digital formats.

One very expensive component of the systems development and support required for digital products is the system for royalty reporting. The proliferation of digital platforms and price points and the fragmentation of the marketplace substantially complicate accounting for digital sales. For every million dollars of subscription services revenue EMI earns there are tens of millions of separate transactions to process. We have had to reengineer our systems to make this kind of effort possible.

At the same time as we are creating a new and complex digital distribution chain, we still have our legacy physical product distribution chain, with all the costs of sales, manufacturing, distribution and returned goods that we have always had. As our physical product sales have fallen, and the "brick and mortar" retail world has contracted with the demise of major retailers like Tower Records, we are left with a smaller base on which to support our costs of physical product distribution.

Music publishers and songwriters will benefit greatly from the new digital income streams being developed by record companies, but they make little or no contribution to the ongoing costs of servicing digital distribution accounts or the tremendous investment in infrastructure and systems required for the migration to the digital marketplace. They will receive mechanical royalty income and other streams of income such as performance royalties for every sale or exploitation resulting from the release of new digital products, while it will take us years to recover our investments in the digital marketplace. Simply stated, music publishers and songwriters share in all of the benefit from the digital transition and little of the risk.

B. The Challenge of Creating Artist Brands in the New Marketplace

As EMI Music has adapted rapidly to the digital marketplace, our sales strategy has shifted increasingly toward creating and marketing exciting, innovative artist brands to attract consumers to pay for the artist's music in one or more of numerous formats. Today, the launch of any album involves additional investment and creativity to coordinate the rollout and marketing of not only the album, but numerous related products, including singles, videos, and ringtones, across multiple distribution platforms.

The process of launching an artist brand has become more challenging in the current retail environment. As physical sales have declined and music retailers have consolidated, fewer retail outlets carry fewer products. The major retail outlets that remain routinely request exclusive extra content that drives up costs still further. We have to record and master more tracks, develop more content (including audio/visual content such as "B-roll" footage), and otherwise respond to the demands from retailers (both in traditional record stores and online) for exclusive extras.

At the same time, radio stations play a narrower selection of sound recordings, the digital market is much more fragmented, and the general proliferation of media outlets of all types has made marketing more difficult and expensive. Coordinating the launch of an artist brand and maintaining it across MTV and other television outlets, radio and satellite radio, print media, ringtone distributors and multiple internet outlets, including the iTunes website, other download services, and subscription services, requires far more effort than following the traditional marketing pattern for physical products. At a time when we are cutting employees, we need more people than ever to carry out these multi-product, multi-platform marketing campaigns.

The digital marketplace is also characterized by greater consumer interest in individual tracks than in full-length albums. We are thus investing to market individual tracks to multiple outlets, while individual track-based sales generate less revenue than album sales. We are also taking creative steps to make albums and other bundles in digital format attractive to consumers, for instance by adding video footage or other supplemental material to albums.

As a general rule in most genres of music, music publishers play almost no role – and take very little risk – in breaking new artists and marketing both new and established artist brands. While publishers sometimes help an artist prepare demos (demonstration tracks) or provide artists who are also songwriters with advances, they frequently wait to sign an artist until the artist has a deal with a record label. Publishers never cover a share of the sound recording production costs, video production costs, marketing expenses or tour support costs.

C. The Devastating Impact of Piracy

I have been in the music business since before the first rate-setting proceeding in 1981, and I can say unequivocally that the last half-dozen years have been the most difficult economic times we have faced at EMI Music and in the recording business as a whole. We have always seen swings in our sales based on factors such as format shifts and business cycles, but the relentless decline in sales we have faced since 1999 is without precedent. One of the principal causes (if not the principal cause) of that decline has been digital piracy of sound recordings, which has made it very easy for consumers to acquire music for free on illegal peer-to-peer ("P2P") file-sharing sites or on pirated recordable CDs ("CD-Rs"). The consequences of digital piracy on our business are much more severe than the copying of cassette tapes we worried about back in 1981 and the illegal CD manufacturing plants we were concerned about in 1997. We have always fought piracy of physical product, but with the advent of digital piracy, its impact has become a vastly larger business issue.

Piracy at the start of the digital age devastated EMI Music at the same time we had to take on the disruption and risk inherent in the fundamental shift from the physical CD to digital products. The recording industry and EMI Music have been through many format shifts before and there is a point at which each one is difficult before it is apparent that a new technology reflecting significant investment will be accepted in the marketplace, but this transition is more fundamental, and its difficulties have been greatly compounded by the effects of digital piracy. While the recording industry has achieved some success by putting some of the major illegal file-sharing services out of business, we expect a substantial level of digital piracy, well above the level of physical piracy that existed in 1981 or even 1997, to continue through the five-year period for which the mechanical royalty rate is being set.

My EMI colleague Victoria Bassetti will testify concerning some of the impacts of piracy on our business, including the sharp decline in sales, the constraints on our pricing, and the extraordinary amount of resources that EMI has devoted during the last several years to fighting piracy. I will focus on the economic impacts on our core business – our ability to nurture artists and exploit sound recordings.

- Contraction of Business – Overall North American sales at EMI Music have declined [redacted] since 2000. Outside of North America, EMI has had to exit some markets entirely due to the effects of piracy.
- Layoffs – Since 2000 our workforce has shrunk by close to [redacted]%. In 2000, EMI Music had about [redacted] employees in the U.S., and today we are down to about [redacted]. In addition to staff cutbacks in many areas, we elected to outsource our U.S. CD manufacturing business and close down our internal manufacturing operation.
- Shrinking Artist Rosters – As the impact of digital piracy hit EMI Music, we cut back on the number of roster artists signed to our labels. In 1999, EMI Music labels had more than [redacted] artists worldwide. Today, we have closer to [redacted]. These artists are required

to prove their economic viability much more quickly than in the past. In today's environment, groups like Pink Floyd and Queen may have been cut from our roster before they achieved their breakthrough hit albums.

- Decline in Sales for Successful New Releases – Sales results for even the most successful new releases have declined across the recording industry. This decline is most apparent when looking at top ten album sales. Total sales of top ten albums per year have been almost cut in half since 2000. While the top ten selling albums accounted for [redacted] of the total units sold in 2000, by 2005 the top ten accounted for only [redacted] of the total albums sold. This represents a [redacted] compound annual growth rate decline in top ten sales since 2000. The decline in top ten sellers is particularly important because record companies depend on hit records to be profitable. Albums that we would have expected to sell over a million copies in 1999 often sell only a few hundred thousand copies today. In addition, successful albums are not staying on the charts as long; sales are falling off dramatically after a week or two. We believe strongly that these effects are the result of digital piracy, which puts sound recordings into circulation on P2P sites and pirated CD-Rs immediately after (and usually somewhat before) the official release of an album.

In view of these effects, fighting piracy has been one of our top corporate priorities. I understand that Victoria Bassetti will also testify concerning what we have done and invested to fight piracy. Music publishers have done little to assist the recording industry in the epic battle with digital pirates. By contrast with the situation of the record companies, music publishers are cushioned from some of the direct effects of piracy. Although writers and publishers have suffered some decrease in their mechanical royalty income as record sales have declined due to piracy, that effect has been mitigated by mechanical royalty rate increases. They also benefit from multiple streams of royalty income (including public performance income), which have grown over the last half-dozen years, but which are much less significant for record companies.

II. CHANGES ARE REQUIRED IN THE MECHANICAL ROYALTY RATE AND STRUCTURE

The availability and pricing of mechanical licenses have become issues at the highest levels for EMI Music as we have sought to bring to the market and support new products and services, including subscription services, multisession discs, and mastertones. The inflexible cents rate royalty structure and high rate, coupled with disputes over how the rate structure applies to new kinds of offerings, have constrained our ability to adapt rapidly to the changing marketplace and at times made it economically infeasible for us to give consumers the value they expect.

There are two major problems with the "penny rate" mechanical license fee structure that applies in the United States. First, the rate is just too high, to the point where it significantly impedes our ability to create and market album products that satisfy consumer interests. The problem is a vicious circle – if we cannot create enough new albums, we will not achieve the fair income that will in turn allow us to continue to create and distribute more albums. Second, the penny rate structure no longer works. It is not flexible enough in a world where consumer expectations drive record labels to enhance product offerings. We need a percentage of revenue rate that will allow us to adapt quickly to continuing changes in the multi-faceted marketplace and that will more equitably spread the risk of investment in that marketplace so that the music publishers have some share in it.

A. Reducing the Cost of Mechanical Royalties is Important to the Health of the Music Industry

In order to remove the constraints on the exercise of our creativity in this transitional marketplace, and allow us to maximize the availability of creative works to the public, the mechanical rate must be adjusted to reflect existing recording industry economic conditions, which are significantly worse now compared with conditions in 1981. I have reviewed the RIAA rate request, and I support RIAA's proposal to set the mechanical royalty rate at 7.8% of wholesale revenues, except in the case of on-demand streams through subscription services (where the rate would be 9.6% of the applicable performance royalty). I believe these rates are appropriate for our current economic circumstances.

Mechanical royalties are a large input cost that directly affects the profitability outlook for every album. As mechanical royalty rates have risen and the number of songs per album has increased, mechanical royalties have been a significantly greater share of our costs. In an environment where unit sales have declined, resulting in higher per album fixed costs and overhead, and album prices have declined as well, mechanical royalty rates at these levels simply are not sustainable.

Consumers expect more content for their entertainment dollars today. In general, unless we reach an agreement with the music publisher or artist who is a singer/songwriter to limit mechanical royalty costs, we cannot undertake a project that includes extra content and maintain the economic viability of the release. When we are unable to obtain reduced rates or negotiate a cap on the number of songs included on a particular release, we are often forced to sacrifice our margin or give up valuable marketing dollars in order to pay mechanical royalties. Another option is to release the project supported by an adequate marketing budget and price the product at a premium price point, but then the consumer may not perceive extra value in the product. As a result, we fail to satisfy consumer demand, and – in many cases – we are unable to obtain an adequate return on our investment. The current penny rate structure poses additional problems in the digital world. For example, EMI has not yet been able to explore a digital marketing strategy that includes selling permanent downloads at a reduced price point, because of the disproportionate share of wholesale revenue that would be allocated to copyright costs absent an arrangement with each publisher to accept reduced rates.

RIAA's rate proposal addresses the trend of increasing mechanical royalty costs and gets us back on course in terms of the percentage of wholesale revenue we have paid the publishers historically and internationally. Mechanical royalties as a percentage of our wholesale revenues have been increasing as prices have fallen. This trend is apparent when mechanical rates in the United States are compared to those in the rest of the world. Over my career, and particularly in the last decade, we have gone from having among the lowest mechanical rates in the world to having the highest rates in the world. Any additional increase in the rate would be highly disruptive and would exacerbate the more difficult economic climate faced by the recording industry in comparison to 1981.

Record company investment drives the businesses of both record companies and publishers. With reduced mechanicals costs, we will be able to invest more in our core functions of finding and breaking new artists, making and marketing great albums and creating memorable hits, which will benefit publishers as well as artists and record companies.

B. A Percentage Royalty Will Lead to More Equitable Sharing of Risk Between Record Companies and Publishers

The current mechanical royalty rate structure causes record companies to bear almost all of the risk, while the publishers bear almost none of it. EMI Music and other record companies take tremendous risks to create exciting new sound recordings and bring them to the notice of the public. We bet on artists and the success of albums, and if too many of our albums fail, we suffer drastic economic consequences. On the other hand, publishers are paid from the first unit sold and bear little risk. A record company can easily lose money on an album even by an established artist, and EMI Music frequently does so even when an artist had a successful first album or sells hundreds of thousands of albums. Music publishers do not take this risk.

Decades ago, music publishers used to do more to bring songs and artists to the attention of record labels and help writers develop their music. Today, apart from the unique case of country music in Nashville, most publishers no longer actively develop writers' careers but instead merely make advances and collect and administer royalties. In sum, any minimal music publisher involvement pales in comparison with the investment the record company puts into developing the artist, creating the sound recordings, and marketing the album, as well as the substantial risk the record company takes that an album will never be profitable.

Moving to a percentage royalty structure would help to address the disparity and reallocate risk. Music publishers would share in the success or failure of record company investments based on the wholesale revenues generated by those investments. A percentage rate would provide us with predictable mechanical costs at any price point, and would have the very important effect of making our mechanical costs variable costs that rise and fall with the success or failure of an album. Music publishers currently have all of the upside while taking on little risk and making no contribution from their margin. A percentage rate will be more equitable because publishers will continue to see the upside and share in our successes and will always get paid, but will not gain windfalls on products that are not profitable for the record company. Publishers should "share" in some of the risks we take to break new artists, to create new albums of sound recordings and to market albums and related products across numerous media outlets.

After all, when the risk leads to success – and even before – they receive a generous share of the return.

Conclusion

The outcome of this proceeding will have a significant impact on record companies and our ability to adjust to the realities of the changing marketplace. When we succeed at this task the music publishers and songwriters will benefit directly from each product we sell. Under these circumstances, the risks inherent in developing the digital future of the recording industry should be allocated so that publishers and songwriters share those risks just as they share our successes.

I declare, under penalty of perjury, that the foregoing testimony is true and correct to the best of my knowledge.

David Munns

Date: Nov 29 2006

<u>Exhibits Sponsored by David Munns (Restricted)</u>

Exhibit Number	Description
B-201-DR	List of 93 Products for Coldplay X&Y Album